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SUBJECT: Treasury Visit to Hanoi: Macroeconomic Uncertainty, Tax Treaty Negotiations and Chiang Mai Progress

¶1. (SBU) Summary. During Treasury Financial Attach???? Seth Bleiweis' January 21-22 trip to Hanoi, Vietnamese economic officials acknowledged the recent policy shift towards fiscal and monetary tightening that began in November 2009, focusing on the control of inflation which has now risen for five consecutive months. There was also acknowledgement that the political pressures of the coming 2011 Communist Party Congress may make it hard for policymakers to chart the steady monetary policy course necessary to successfully control inflation. Treasury's interlocutors suggested that Vietnam's ongoing balance of payments problems are not yet critical, but that economic officials do not have a clear policy approach to resolve Vietnam's persistent macroeconomic imbalances. Discussing possible double tax treaty negotiations, the General Department of Taxation made a critical concession, asserting that tax sparing would not be a part of any discussions on a double tax treaty. The Ministry of Finance (MOF) also stated the Government of Vietnam's (GVN) objective for full signing of the Chiang Mai Initiative for bilateral swap arrangements by the end of March
¶2010. End summary.

A Clear Macroeconomic Shift, But an Uncertain Course

¶2. (SBU) The GVN will be focused on stabilization of the macro economy in 2010, said Vice Chairman Vu Viet Ngoan of the National Assembly (NA) Economic Committee. Ngoan stated that the NA spent a lot of time reaching this consensus in October 2009 - when the GVN began shifting from growth-focused macroeconomic policies to those focused on controlling inflation - asserting that the NA was the first to raise the need for stabilizing the economy. "Stability provides the foundation for meeting Vietnam's growth target," said Ngoan. However, the coming 2011 Communist Party Congress will really challenge the GVN's ability to chart a steady monetary course, according to International Monetary Fund (IMF) Regional Representative Benedict Bingham. This concern regarding policy consistency was echoed by Vice Chairman Ha Huy Tuan of the National Financial Supervisory Commission (NFSC), who raised his worry regarding the tension between Vietnam's growth and inflation targets, stating that the GVN "wants the country to have significant achievement before the party congress." Tuan suggested that the implementation of economic policy will be a challenge and that policy could "come back to the old times, with the government intervening."

Rising Inflation the Chief Economic Risk

¶3. (SBU) Inflation is now broadly recognized as the chief risk to Vietnam's economy. The State Bank of Vietnam (SBV) acknowledged that the fiscal and monetary loosening of 2009 may cause inflation

in 2010. The SBV stated that inflation risks have risen lately, along with the rising global economy. January inflation was 7.6 percent year-on-year, the highest in nine months and a sign that double digit inflation is likely in 2010. NA Vice Chairman Ngoan also said he expects increased price pressures in 2010, due in part to global recovery, as well as to wage increases and credit growth of almost 40%. Ngoan said the GVN will have to tighten monetary and fiscal policy and "lessen the rate of loosening." He suggested that keeping inflation within 7 percent will be difficult and that "8 percent CPI growth rate will be acceptable." NFSC Vice Chairman Tuan also said inflation is the "number one" focus, with the budget deficit coming second. However, the GVN wants both growth and price stability. As a result, he is concerned the GVN may undertake month-by-month management of the inflation-growth balance, tightening and loosening monetary and fiscal policy in response to monthly inflation numbers. Vice President Nguyen Dinh Cung of the Central Institute for Economic Management (CIEM) - the think tank for the Ministry of Planning and Investment - stated that his analysis shows that inflation in Vietnam is closely linked with credit growth, with about a six-month lag, and that CIEM, therefore, expects inflation to pick up around April or May 2010.

Continuing Balance of Payments and Foreign Exchange Problems

¶4. (SBU) Vietnam's foreign exchange (forex) reserves likely now stand around $15 - $16 billion, according to IMF's Bingham. Because Vietnam's forex reserves are too low to effectively defend the value of the currency, the success of Vietnam's recent shift in monetary policy will be critical to stabilizing the dong, said Bingham. On the upside, he noted that the margin of dong trading in the "free" or black market has narrowed to as little as 100 dong outside the official band in the interbank market, down from a premium of over 1,000 dong. On the downside, the spread in the gold market remains 3 to 4 percent above world gold prices, says Bingham. He said that there are now some signs of people beginning to sell foreign exchange to the banks, but the question is "whether this is a lull in the storm or a fundamental shift." The current lull may be temporary. Dollar demand is now off its peak as businesses close for the Tet holiday, Tet remittances flow in from abroad and SOEs sell forex into the market. The GVN's recent directive instructing SOEs to sell dollars to the banks netted about $700 million - $1 billion, according to the SBV. (Note: Recent local press reports suggest that increased deposits amount to only about $450 million.)

¶5. (SBU) Asian Development Bank (ADB) Country Economist Bahodir Ganiev stated that Vietnam is still experiencing a persistent shortage of forex, while Mr. Cung of CIEM foresees increasing forex shortages. NA Vice Chairman Ngoan, however, suggested that a rising global economy and increased foreign direct investment (FDI) might resolve Vietnam's current balance of payments problem. Deputy Director Nguyen Van Anh of the SBV Foreign Exchange Department stated that the GVN is also targeting relieving the trade deficit to reduce Vietnam's balance of payments problem. Anh noted the SBV had also recently reduced dollar reserve requirements for Vietnamese banks to reduce the pressure on dollar liquidity. Anh added that the SBV doesn't see a substantial gap between dollar supply and demand and suggested that if the GVN can fully mobilize the dollars currently in the banking system there will not be a shortage of dollars. The problem is that "people won't sell dollars to banks and dollar borrowing is increasing," said Anh. He expects an improved dollar supply in 2010, aided by the GVN's recent successful $1 billion sovereign international bond issuance.

Possibility of Devaluation and Interest Rate Hikes

¶6. (SBU) NA Vice Chairman Ngoan suggested that Vietnam would need

to maintain forex flexibility in 2010, noting some calls for further devaluation to support exports, following on the GVN's 5.4 percent devaluation of the dong in November 2009. Ngoan suggested that some devaluation would be acceptable, but "strong devaluation" is not, suggesting that a "strong devaluation" would create pressure on inflation and would increase the dollar debt of VN businesses. Further, Ngoan argued that many of Vietnam's key commodity exports - including crude oil, minerals and certain agricultural products - are not sensitive to exchange rates because they are priced in dollars.

¶7. (SBU) Looking forward, IMF's Bingham sees economic malaise more likely than monetary panic during the coming year, with continued forex rationing and additional administrative measures likely to be applied to address continuing forex shortages. Bingham is not convinced of the need for depreciation, suggesting that the dong exchange is not fundamentally misaligned -the dong is already effectively depreciating against its regional partners because of its peg to the depreciating dollar - but the GVN's monetary policies are misaligned. For example, the GVN has recently allowed interbank interest rates to fluctuate too broadly; up to 15%, then down to 8% on monetary tightening. Bingham argued that the current 8% policy base rate is too low and banks can't mobilize capital under the current rate cap. Stating that GVN's monetary policy is out of step with the market, he said that there may soon be calls for an increase in the policy base rate.

No Coming Independence for State Bank

¶8. (SBU) There now appear to be no short or mid-term prospects for

a more independent Vietnamese central bank. While Vietnam previously had a "roadmap" for an independent central bank, the global financial crisis led to its reconsideration and the GVN is no longer pursuing plans for SBV independence, according to NFSC Vice Chairman Tuan. The SBV agrees there is no medium term plan for SBV independence, despite SBV staff desires to the contrary. Further, according to the SBV, given that revisions to the SBV law are just now in their final drafts, it will likely be another 3-5 years before there will be another push for further legislative SBV reform. Echoing NFSC comments, SBV Deputy Director Nguyen Van Anh stated the financial crisis has paused moves to further liberalize Vietnam's capital markets and that the SBV still faces calls for further tightening of currency controls. Mr. Anh suggested that, as the economy grows, market forces will eventually dictate the need for further currency flexibility. But while he sees further currency flexibility as likely in the next three to four years, he does not anticipate a full currency float.

General Department of Taxation Agrees to Treasury Precondition Regarding Tax Sparing

¶9. (SBU) Following on earlier GVN diplomatic notes requesting tax treaty negotiations, Bleiweis met with the General Department of Taxation (GDT) of the Ministry of Finance to discuss possible negotiations for a US-VN treaty on the avoidance of double taxation. During the meeting, GDT Deputy Director General Le Hong Hai stated that, while GDT believes the issue of tax sparing should not be a precondition to US-VN tax negotiations, in order to address the bottleneck in current discussions, "we assert that tax sparing will not be a part of discussions on a double tax treaty."

¶10. (SBU) DDG Hai expressed her appreciation for US interest in

possible tax treaty negotiations. She suggested that, during earlier tax treaty discussions in 2007, there may have been a misunderstanding about GDT's position on tax sparing. At that time, tax sparing was not raised as a demand, but only as a point of discussion in seeking to understand each other's tax policies. Bleiweis inquired regarding GDT's record on other key Treasury issues of tax information sharing and treaty shopping. DDG Hai opined that these issues should not be points for worry as, based on prior US-VN tax discussions in 2007, GDT is not aware of any US reservations regarding GDT's positions on either tax information sharing or treaty shopping. Econoff offered to work with GDT to clarify any outstanding Treasury questions regarding tax information sharing, treaty shopping and quantifying the economic benefits of a prospective US-VN tax treaty.

¶11. (SBU) In response to US questions regarding information sharing and treaty shopping, DDG Hai raised GDT's concern that the US seemed to be raising the bar on its preconditions to starting negotiations. She said a tax treaty with the US is a priority for GDT and asked whether the US is really interested in starting negotiations, expressing her disappointment that GDT's concession on tax sparing may not ensure the start of negotiations. Bleiweis clarified that his questions sought to set realistic expectations and maximize the possibility of an earlier start to negotiations.

Chiang Mai Initiative to be Signed by March 2010

¶12. (SBU) ASEAN has strengthened its financial cooperation over the past year, stated Deputy Director General Nguyen Ba Toan of the Ministry of Finance (MOF) International Cooperation Department. According to MOF, the first stage of this cooperation will be the signing of the Chiang Mai Initiative (CMI) to create a network of bilateral swap arrangements among the ASEAN+3 countries. The second stage will be the multilateralization of these arrangements. MOF noted that Vietnam is currently the co-chair of ASEAN+3 and is in favor of multilateralization. MOF suggested that the CMI would not only help countries manage balance of payments crises, but would also send a signal of stability during such crises.

¶13. (SBU) The GVN's objective is for full signing of the CMI by the end of March and MOF is confident that all ten countries will sign. The ASEAN+3 countries have already completed consultations and reached consensus on the CMI, according to MOF. Vietnam has already approved the CMI and only procedural approvals in other countries remain outstanding. The MOF noted that the CMI had not yet been drawn upon because it requires an effective monitoring regime that is not yet in place. There is no timeline for implementing a CMI monitoring mechanism as the member countries are still waiting for final signatures and there will be some gap between signing, full implementation and any funds transfers. MOF added that the ASEAN financial ministers are in favor of the G20 Framework for Balanced Growth, and that the ASEAN financial ministers appreciated their meeting with Treasury Secretary Geithner on the margins of APEC. MOF encouraged further dialogue with Treasury, suggesting a meeting this year on the margins of ASEAN as a possibility.
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